

Testimony of Steven T. Miller
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Internal Revenue Service
before the
Senate Subcommittee on Financial Management, the Budget, and
International Security of the Senate Committee on Governmental Affairs
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THANK YOU, MR. CHAIRMAN, FOR THE OPPORTUNITY TO TESTIFY REGARDING QUALIFIED TUITION PROGRAMS. MY DIVISION OF THE IRS IS RESPONSIBLE FOR ENSURING THAT THESE PROGRAMS MEET THE REQUIREMENTS FOR TAX EXEMPTION. TODAY I WILL DIVIDE MY REMARKS INTO TWO PARTS, FIRST OUTLINING THE TAX RULES RELATING TO THESE PROGRAMS AND SECOND, EXPLAINING HOW WE AT THE INTERNAL REVENUE SERVICE INTERACT WITH THE PROGRAMS.

SECTION 529 OF THE INTERNAL REVENUE CODE EXEMPTS "QUALIFIED TUITION PROGRAMS" FROM FEDERAL INCOME TAX PROVIDED A PROGRAM MEETS A NUMBER OF REQUIREMENTS.

THE FIRST REQUIREMENT IS THAT THE PROGRAM MUST BE **ESTABLISHED AND MAINTAINED** BY A STATE, AN AGENCY OR INSTRUMENTALITY OF A STATE, OR BY ONE OR MORE ELIGIBLE POST-SECONDARY INSTITUTIONS. THUS, THE PROGRAM MAY BE EITHER A STATE PROGRAM OR A PROGRAM ESTABLISHED AND MAINTAINED BY ELIGIBLE PRIVATE COLLEGES AND UNIVERSITIES.

SECOND, THE OPERATION OF THE PROGRAM IS LIMITED TO ONE OF TWO DESIGNS. STATE PROGRAMS MAY BE EITHER A **PREPAID OR SAVINGS PROGRAMS**.

PROGRAMS ESTABLISHED BY ELIGIBLE PRIVATE COLLEGES AND UNIVERSITIES MAY OFFER ONLY A PREPAID DESIGN. UNDER A PREPAID PROGRAM, A PERSON PURCHASES TUITION CREDITS OR CERTIFICATES FOR QUALIFIED HIGHER EDUCATION EXPENSES.

UNDER A SAVINGS PLAN MAINTAINED BY A STATE, A PERSON CONTRIBUTES TO AN ACCOUNT THAT IS ESTABLISHED FOR THE PURPOSE OF MEETING THE BENEFICIARY'S QUALIFIED HIGHER EDUCATION EXPENSES. THE BALANCE IN THE ACCOUNT MAY GO UP OR DOWN DEPENDING ON HOW THE ACCOUNT IS INVESTED.

WHEN WE TALK ABOUT QUALIFIED HIGHER EDUCATION EXPENSES IN SECTION 529, WE MEAN EXPENSES THAT INCLUDE TUITION, FEES, BOOKS, SUPPLIES, AND EQUIPMENT REQUIRED FOR THE ENROLLMENT OR ATTENDANCE AT AN ELIGIBLE EDUCATIONAL INSTITUTION. CERTAIN ROOM AND BOARD EXPENSES ARE ALSO INCLUDED.

THE THIRD REQUIREMENT IS THAT AN **INDIVIDUAL MUST BE DESIGNATED** AS THE BENEFICIARY AT THE COMMENCEMENT OF PARTICIPATION IN A PROGRAM.

OTHER REQUIREMENTS INCLUDE:

- THAT ONLY CASH CAN BE CONTRIBUTED
- THAT THERE MUST BE A SEPARATE ACCOUNTING FOR EACH BENEFICIARY
- THAT PRIVATE COLLEGE AND UNIVERSITY PROGRAMS MUST EMPLOY A TRUST, AND
- THAT AN INTEREST IN THE PROGRAM MAY NOT BE USED AS SECURITY FOR A LOAN.

THE FINAL REQUIREMENT I WILL MENTION IS THAT THE ABILITY TO SELECT AND CHANGE INVESTMENTS IN A PROGRAM IS LIMITED. CONTRIBUTORS AND BENEFICIARIES ARE NOT ALLOWED TO DIRECT THE INVESTMENT OF CONTRIBUTIONS OR EARNINGS. HOWEVER, A PROGRAM DOES NOT VIOLATE THIS REQUIREMENT IF SELECTION IS PERMITTED AMONG DIFFERENT BROAD-BASED INVESTMENT STRATEGIES DESIGNED EXCLUSIVELY FOR THE PROGRAM.

TURNING TO RULES RELATING TO CONTRIBUTIONS, UNDER SECTION 529 THERE IS A LIMITATION ON THE AMOUNT THAT CAN BE CONTRIBUTED.

CONTRIBUTIONS MADE ON BEHALF OF AN INDIVIDUAL MAY NOT EXCEED THE AMOUNT NECESSARY TO PROVIDE FOR HIS OR HER QUALIFIED EXPENSES. THERE IS NO STATUTORY DOLLAR LIMITATION, BUT A SAFE HARBOR WAS PROVIDED IN THE PROPOSED

REGULATIONS PERMITTING CONTRIBUTIONS FOR 5 YEARS OF ENROLLMENT.

CONTRIBUTIONS TO A PROGRAM ARE NOT DEDUCTIBLE FOR FEDERAL INCOME TAX PURPOSES. WHETHER A DEDUCTION IS AVAILABLE ON A CONTRIBUTOR'S STATE INCOME TAX RETURN DEPENDS UPON STATE LAW.

LET ME MOVE TO THE TAX RULES RELATING TO DISTRIBUTIONS. DISTRIBUTIONS ARE NOT TAXED IF THE DISTRIBUTION IS USED TO PAY QUALIFIED EXPENSES. THE EARNINGS COMPONENT OF A DISTRIBUTION IS GENERALLY SUBJECT TO INCOME TAX AND AN ADDITIONAL 10-PERCENT TAX IF THE DISTRIBUTION IS USED FOR NON-QUALIFIED EXPENSES.

SPECIAL ESTATE AND GIFT TAX RULES ALSO APPLY.

THAT IS A QUICK OUTLINE OF SOME OF THE TAX RULES. NOW LET ME TALK ABOUT HOW THE IRS ADMINISTERS SECTION 529. STATE PROGRAMS ARE NOT REQUIRED TO RECEIVE A DETERMINATION OR RULING IN ORDER TO OPERATE.

BY CONTRAST, PROGRAMS ESTABLISHED AND MAINTAINED BY ELIGIBLE PRIVATE COLLEGES AND UNIVERSITIES MUST RECEIVE A RULING FROM THE IRS.

PROGRAMS SEEKING RECOGNITION OF STATUS REQUEST A PRIVATE LETTER RULING. NOTE THAT SECTION 529 DOES NOT REQUIRE PROGRAMS TO

FOLLOW A PARTICULAR PROTOTYPE. SO EACH REQUEST PRESENTS UNIQUE ISSUES, AND A PROGRAM MAY HAVE TO MODIFY ITS OPERATION BEFORE WE CAN CONFIRM ITS STATUS.

IN TERMS OF REPORTING, A PROGRAM GENERALLY HAS NO REQUIREMENT TO FILE A TAX OR INFORMATION RETURN REGARDING ITS OPERATIONS WITH THE IRS. THIS TREATMENT IS CONSISTENT WITH TREATMENT PROVIDED TO STATE GOVERNMENTAL UNITS AND THEIR AFFILIATES. HOWEVER, IF A PROGRAM HAS UNRELATED BUSINESS INCOME, IT IS REQUIRED TO FILE A FORM 990-T.

IN TERMS OF REPORTING TO ITS PARTICIPANTS, A PROGRAM IS REQUIRED TO PROVIDE AN ANNUAL ACCOUNT STATEMENT SHOWING THE TOTAL ACCOUNT BALANCE, THE CONTRIBUTIONS IN THE ACCOUNT, EARNINGS, AND DISTRIBUTIONS FROM THE ACCOUNT.

A PROGRAM MUST ALSO ISSUE A FORM 1099-Q FOR EACH DESIGNATED BENEFICIARY WHO HAS RECEIVED A DISTRIBUTION FROM THE PROGRAM. A FORM 1099-Q IS ALSO ISSUED WHEN MONEY IS TRANSFERRED BETWEEN PROGRAMS.

THANK YOU AGAIN FOR THIS OPPORTUNITY. OF COURSE I AM AVAILABLE FOR ANY QUESTIONS.